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DEPARTMENT FOR EUR/CE, EB/OMA, INR/EC
TREASURY FOR ERIC MEYER, JEFF BAKER, LARRY NORTON

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Classified By: ACTING P/E COUNSELOR JON MARTINSON; REASONS 1.4 (B) AND (D)

¶1. (SBU) Summary. In the period between January 1 and March 5, 2009, the Hungarian forint lost nearly 15 percent of its value against the euro and approximately 23 percent against the dollar. Hungarian policymakers are becoming increasingly concerned about the forint's volatility, but have not been successful in stabilizing the currency as it continues to reach new record lows. Although the trend is visible in other currencies in the region, Hungary's weak macroeconomic fundamentals and lackluster growth in recent years differentiates Hungary from its neighbors, and makes it particularly vulnerable to a loss in investor confidence. These problems include Hungary's high debt-to-GDP ratio, high foreign currency exposure, and the greater than expected economic downturn this year. Of particular concern is the impact of the depreciating currency on the large number of households with euro or Swiss franc denominated consumer loans, as well as the large levels of foreign currency denominated government debt.

¶2. (C) In response, the National Bank's Monetary Council announced this weekend that it stands ready to use its full range of monetary policy tools to help stabilize the market, although many analysts currently believe an emergency rate hike to help stabilize the currency is unlikely. The government is also pursuing economic reforms, and the Prime Minister announced the possibility of expanding reforms in light of the recently issued proposal by the non-partisan "Reform Alliance" group of economists and business leaders. At the EU and eurozone level, however, Hungary's engagement is viewed by many as ineffective and potentially detrimental. The forint is unlikely to stabilize until the global financial climate begins to improve and until investors are convinced that Hungary is irreversibly down the road to reform. End summary.

THE FALLING FORINT

¶3. (SBU) In the period between January 1 and March 5, 2009, the Hungarian forint lost nearly 15 percent of its value against the euro (and nearly 25 percent since October 2008), and approximately 23 percent against the dollar. On March 6, the forint closed at around 315 to the euro, a historical low, and well above what many analysts believe to be the equilibrium rate of around 280. Hungarian policymakers are becoming increasingly concerned about the forint's volatility, but seem unable to stabilize the currency as it continues to break psychological barriers and reach new

record lows.

CORE CAUSES

¶4. (SBU) Hungary's currency movements in 2009 have generally followed a regional trend, with the Polish zloty and Czech corona experiencing similar declines against the euro during this period. Some analysts believe, however, that Hungary's currency is beginning to "decouple" from other regional currencies, given Hungary's weaker macroeconomic fundamentals and greater foreign currency exposure. The introduction last week on interbank markets of Zloty/Forint and Czech Corona/Zloty currency trading pairs could make this more likely as well, according to some analysts, by allowing speculation between the currencies without requiring the euro as an intermediary currency.

¶5. (SBU) Hungary is often viewed as the "weak performer" in the region. Although trending downward, years of high deficits have translated into a high debt-to-GDP ratio and has raised Hungary's debt servicing needs. The cheap availability of foreign credit caused a "foreign currency boom" over the past few years, and has resulted in a large number of Hungarian households holding foreign currency denominated loans which are vulnerable to exchange rate swings. A deeper than expected recession forecast for 2009 also differentiates Hungary from many of its regional neighbors. The National Bank's Monetary Council admits that the selling pressure on Central European currencies reflects a deterioration in sentiment towards the economies of Central and Eastern Europe, "and the Hungarian economy in particular". Some analysts believe that the continuous

demand for euros or Swiss francs by the large number of Hungarian foreign currency loan debtors for redemption or repayment further contributes to the weakening of the forint.

¶6. (SBU) Analysts also attribute the steep slide of the forint and other regional currencies this year to the continued negative global economic climate, including worse than expected growth forecasts in Western European export markets, and continued investor risk aversion and concern about the health of emerging markets. Other factors include reports of growing problems faced by Western European banks with significant exposure in Central and Eastern Europe.

¶7. (SBU) On the other hand, many bankers and analysts attribute the rapid pace of the recent currency depreciation to "panic mentality." The Hungarian National Bank (MNB) believes the accelerated depreciation of the forint has been caused primarily by "a departure of expectations from economic fundamentals" and argues that domestic institutional sectors have already started to adjust to the changed international financing environment. They maintain that the domestic banking sector continues to be stable, and funding from foreign parent banks to domestic banks continues to be high.

¶8. (SBU) During this period, the forint has been particularly vulnerable to rumors, speculation about the health of the economy, and bad economic news in general. For example, unsubstantiated reports in January that the IMF was concerned about Hungary's implementation of its stabilization package commitments caused the forint to weaken to then-historic lows against the euro. Similarly, analysts attribute last week's weakening of the forint to new record lows against the euro to a number of external events, including the misinterpretation of President Obama's statements during his press conference with Gordon Brown lumping the situation in Hungary with that of Ukraine; Hungary's failure to initially associate itself with the statement of other Central European banking supervisory authorities cautioning against referring to the economic situation in Central and Eastern Europe in homogeneous terms; and media reports that Prime Minister Gyurcsany's proposal for assistance to Central European

countries was rejected by other EU Member states.

IMPACT

¶9. (SBU) The weakening forint has increased the amount of Hungary's euro-denominated national debt by HUF 874 billion (USD 3.5 billion), nearly 3 percent of GDP. This in turn raises Hungary's already large debt-to-GDP ratio, and increases interest payments on its national debt. It also increases the risk of a possible downgrade in Hungary's sovereign rating by international credit rating agencies. The Monetary Council also cautions that if the forint continued to weaken further, "it would jeopardize the Bank's inflation target directly, through import prices, and through expectations as well as other indirect channels."

¶10. (C) OTP Bank Chief Financial Officer Laszlo Urban cautions that the falling forint also squeezes liquidity out of the banking sector, as banks must exchange more forints for euros to cover their positions in swap transactions, resulting in less money available for lending. He also points out that the depreciating forint reduces households' disposable income, negatively impacting GDP growth and deepening Hungary's recession. He argues that for every 10 percent devaluation in the currency, households' disposable incomes will decline by approximately .7 percent, resulting in a near-equivalent drop in GDP.

¶11. (SBU) If the value of the forint continues to fall, foreign currency borrows will have an increasingly difficult time making their loan payments (REF A), and as former Finance Minister Lajos Bokros notes, "we will have a household debt crisis." In such a case, the rate of non-performing loans would likely increase and create additional stress on the largely foreign-owned banking sector. The government has introduced measures to help insulate borrowers from the most severe impact of these exchange rate risks by seeking commitments from banks to extend loan repayment periods and to allow for the conversion of foreign currency denominated loans to forint-based loans.

¶12. (C) According to OTP's Laszlo Urban, the biggest danger of a continued decline in the value of the forint is if the public begins to panic and start converting more and more

forints to euros, creating a downward spiral of pressure on the value of the currency. He cautions that the current currency value is "close to the danger zone".

ACHIEVING CURRENCY STABILITY

¶13. (SBU) A Uni-Credit analyst described the forint as a feather that is "helpless in the storm of the capital and money markets." Many analysts agree, believing that an improvement in the global financial climate is necessary before the forint will stabilize and strengthen to previous levels.

¶14. (SBU) In extraordinary sessions on March 6 and 8, the MNB's Monetary Council announced that it "stands ready to use the full range of monetary policy instruments at its disposal" to stabilize the currency and bring financial market developments "back into line with the outlook for the real economy." This statement has had a moderate positive effect on currency trading this week. Some, including OTP's Laszlo Urban, argue that an emergency rate hike, like the one undertaken in October, is necessary. Unless the depreciation continues, however, many analysts currently believe it is unlikely that the Hungarian National Bank would raise the already high 9.5 percent base rate to protect the exchange rate, particularly given the potential negative effect on Hungary's already poor growth outlook for 2009.

¶15. (SBU) Former Finance Minister Lajos Bokros points out that the general policy prescription for an economic

situation like Hungary's would be fiscal stimulus and an extreme monetary easing. He notes, however, that the government already used these tools "during the good times," and that neither is possible now. He says the choice is between "further tightening the belt which will deepen Hungary's recession" or the risk of fiscal collapse.

¶16. (SBU) The government continues to focus on fiscal consolidation, which, together with an increase in domestic savings, should help improve Hungary's external balance and help reduce external financing requirements. Prime Minister Gyurcsany announced that formal proposals expected to be submitted soon to Parliament will go even further than measures previously announced, incorporating elements of the non-partisan Reform Alliance proposals (REF B). The successful passage and implementation of these reforms should improve Hungary's macroeconomic fundamentals and help restore long term growth prospects and investor confidence.

COMMENT

¶17. (C) Despite often emphasizing external causes for its current problems, Hungary is continuing its fiscal consolidation efforts, and is taking steps to enact economic reforms, including some which are likely to further alienate traditional socialist party voters (REF C). Although the government's final tax and economic reform proposals have not yet been submitted to Parliament and their passage is not guaranteed, the Government appears likely to win support from the smaller SzDSz and MDF parties, both of which support the basic elements of the non-partisan Reform Alliance proposals. Many view the Prime Minister's most recent EU and eurozone-level efforts as failures, however, including his proposal for a euro 180 billion stabilization fund and the proposal to shorten the time countries are required to be in the ERM-II before adopting the euro.

¶18. (C) Absent a major rate hike, stability in the value of the forint will not likely return until there are signs of improvement in the global financial climate and until investors are convinced that Hungary is irreversibly down the road to reform. If the forint continues to depreciate significantly, there is a risk that the number of non-performing foreign currency loans will increase, putting additional pressure on the financial sector.

¶19. (C) As is often the case in Hungary, the political situation is also impacting investor confidence in Hungary. The Prime Minister's rejected appeal to the EU for a euro 180 billion "stabilization and integration fund" to help Central European financial sectors is causing some observers to view Hungary as both increasingly isolated and increasingly in trouble. At the same time, the opposition's lack of a coherent policy, including Fidesz's Viktor Orban's increasingly populist statements like the suggestion that "at least 50 percent of banks should be headquartered in Hungary"

and his rejection of the Reform Alliance economic recovery plan, is causing others to question whether there is any viable alternative.
Foley